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Secret

DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

International Finance Series No. 34

The World Gold Market: Annual Review for 1971

Secret

ER IM 72-37
March 1972

Copy No. 99

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
March 1972

INTELLIGENCE MEMORANDUM

THE WORLD GOLD MARKET: ANNUAL REVIEW FOR 1971

Introduction

1. This memorandum, one of a series begun shortly after the two-tier market was established in March 1968, reviews and updates developments in both the official and private tiers through December 1971. Attention is focused on the official gold reserve position of the United States, on South African sales, and on the free-market price for gold. The outlook for gold in 1972 is also considered.

Discussion

1971 Highlights

2. US monetary gold stocks fell $864 million in 1971[1] before President Nixon closed the gold window on 15 August. West European nations accounted for the bulk of these purchases. These stocks are now about $9.6 billion, the lowest level since 1935.

3. South Africa, again beset with large payments deficits, sold gold worth about $1.3 billion – some $200 million more than production, but nearly $300 million less than in 1970. Most of its free-market sales of gold – amounting to $1,150 million – were made through a Swiss consortium headed by the Union Bank of Switzerland.

1. Unless otherwise indicated, all dollar amounts are calculated at $35 per troy ounce of fine gold.

Note: This memorandum was prepared by the Office of Economic Research.

4. Free-market prices climbed somewhat erratically during 1971, from below $38 an ounce early in the year to nearly $44 an ounce at year's end. As part of the 18 December Smithsonian currency realignment, the United States agreed to raise the official price of gold to $38 an ounce, the first change in the price of monetary gold since 1934.

The Official Market for Gold

5. By the time President Nixon closed the official gold window on 15 August, US monetary gold reserves had fallen to their lowest level since 1935, declining by $864 million to $10.2 billion.[2] Additional sales of $3 million were made between 15 August and the end of the year, bringing total net US sales to $867 million. Although more than 30 countries purchased gold during the year, eight accounted for 95% of total gross sales (see Table 1). France made two purchases totaling $473 million to

Table 1

US Official Gold Transactions
1971

Million US $

Country	Sales by the United States	Purchases by the United States
Burma		41.9
Turkey		14.6
France	473	
Switzerland	175	
Belgium	110	
Lebanon	35	
Singapore	30	
Netherlands	25	
Finland	20	
Malaysia	10	
Other	23.2	
IMF	22	
Total	923.2	56.5
Net sales	*866.7*	

2. Some $544 million of this total was a liability to the International Monetary Fund that was liquidated in mid-February 1972, reducing US gold reserves to $9.6 billion.

repay a debt to the International Monetary Fund (IMF). The French could not make the repayment in dollars because the IMF's dollar holdings already were above 75% of the US quota. The Swiss, convinced that their dollar holdings were too large, took another $175 million; for the same reason Belgium acquired $110 million. In addition, the United States, in its role as a gold supplier for other countries seeking additional amounts of gold to cover their IMF gold-tranche increases, sold $22 million to the Fund. Only two countries, Burma and Turkey, sold gold to the United States. Both were experiencing balance-of-payments difficulties.

South African Gold Sales

6. Faced with a large – though not record – balance-of-payments deficit for the third consecutive year, South Africa sold its entire output of newly mined gold as well as some from previously accumulated stocks. Total sales of more than $1.3 billion exceeded current output by $220 million. In contrast to 1970 when about 43% of total transactions were with the IMF and with other monetary authorities, in 1971 only 13% were made with official purchasers. With sales exceeding production, reported South African gold reserves fell to $406 million by 31 December 1971 (see Table 2).

7. South Africa's 1971 gold transfers to monetary authorities were $168 million. The IMF purchased $105 million under the "deficit formula" that permits South Africa to make such sales to finance balance-of-payments deficits remaining after sales of newly mined gold. The IMF also received $30 million owed by Pretoria for an increased gold subscription resulting from a larger quota. The remaining $33 million consisted largely of sales to Switzerland as its counterpart of sales to the IMF,(3) to the Bank for International Settlements for South Africa's initial subscription payment, and to Mozambique in an agreement to repatriate earnings by its residents working in South African gold mines. About $10 million of official sales is unaccounted for, but may have been to Tunisia.

The Free Market for Gold

8. South African free-market gold sales during 1971 totaled $1,150 million (1,022 metric tons), a 25% increase over 1970. About three-fourths of the increase came from newly produced gold with the remainder from reserves. In 1971 all newly mined gold was sold on the free market, in

3. Because Switzerland is not a member of the IMF, it technically does not benefit from South African gold sales to the IMF. To compensate for this, South Africa can sell gold directly to Switzerland as a counterpart of its IMF sales.

Table 2

South African Gold Reserves a/
1971

	Million US $
Reported reserves (31 December 1970) b/	628
Production (1971)	1,098
Supply before sales	*1,726*
Sales and other transfers	
To the IMF	135
Deficit formula	(105)
Increased quota subscription	(30)
To other monetary authorities	33
To the free market	1,150
Sales and transfers	*1,318*
Reserves as of 31 December 1971	
Estimated (by subtraction)	*408*
Reported	406
Unexplained difference	2

a. Calculated at $35 per troy ounce of fine gold.
b. Adjusted to reflect a sale to the IMF on 8 January 1971, which is considered as having taken place in 1970.

contrast to 1970, when almost 19% was sold to monetary institutions. Moreover, some $50 million of Pretoria's gold reserves were sold on the free market, nearly all in the last quarter of 1971. Although the Swiss bank consortium headed by the Union Bank of Switzerland continued to purchase the bulk of the free-market gold – at least 720 tons – its share declined from 93% in 1970 to 71% in 1971. Other purchasers were probably London banks and bullion dealers.(4)

4. Some $15 million was sold from South Africa's account with the New York Federal Reserve Bank to a New York subsidiary of a British dealer.

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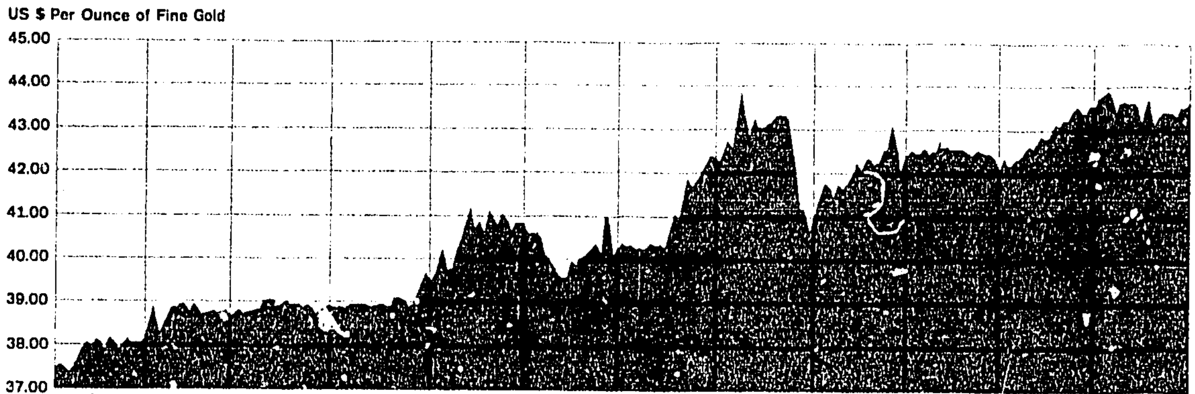
9. Some 46% of the consortium's purchases were received directly from South Africa, usually by airfreight from Johannesburg to Zurich. The remainder was shipped to the United Kingdom and then released to the Swiss banks. UK gold shipments to Switzerland were at least 150 tons less than the volume of South African gold received by the Swiss consortium in Britain. The Swiss, therefore, are apparently selling gold directly on the London gold market.

10. Free-market gold prices, which began the year well below $38 per troy ounce, experienced a relatively steady increase through the first four months of the year (see the chart), with the afternoon London fixing

London Daily* Gold Prices, 1971



*Second Fixing

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set at $39.70 on 30 April. The large dollar inflows into European central banks during the spring of 1971 spurred speculative demand for gold. In May, uncertainty accompanying the West German mark float led to a rise in the price of gold to more than $41 an ounce. Although the free-market price subsequently fell below $40 an ounce. it resumed its climb, reaching $43.94 on 9 August. Following President Nixon's 15 August announcement, speculators apparently began to accept that the price of gold would not be substantially raised; the free-market price dropped to

$40.65 at the end of August. At the end of the year, however, renewed uncertainty surrounding the future of the international monetary system and increased tensions in the Indian sub-continent resulted in an early December high of $43.975.

11. Commercial demand and traditional hoarding were responsible for at least as much of the gold price rise as was speculative demand. Non-speculative demand has exceeded annual non-Communist gold production for several years. Through 1970 the shortfall was met by drawing down the speculative overhang accumulated during the 1967-68 run on the London gold pool. Once this overhang was dissipated the supply-demand imbalance was resolved by rising prices.

12. With the higher free-market prices, South Africa realized a profit of about $5 an ounce above the official price of gold on its sales to the Swiss banks. Although data are available only on the share of free-market sales to the Swiss consortium (see Table 3), other free-market sales probably followed a similar pattern. Thus, total earnings from free-market gold sales amounted to $1,330 million, almost 16% more than sales calculated at $35 an ounce.

Soviet and East European Gold Sales

13. Communist countries' gold sales were modest in 1971. The USSR is known to have sold $22 million worth of gold in the first half of 1971, [redacted] East European gold sales were about $35 million, nearly $30 million by East Germany alone. 25X1

The Smithsonian Agreement and After

14. The basis of the Smithsonian currency realignment was a commitment by the United States to raise the official price of gold by 8.57%. Legislation is now before Congress to raise the official price from $35 to $38 an ounce. This official price change will be the first since January 1934, when it was increased from $20.67 an ounce to $35 an ounce.

15. Following the Smithsonian agreement, South Africa devalued the rand by 12.28% in terms of gold, or 4.76% vis-a-vis the dollar. Thus the floor price paid the South African gold producer was increased 14%, from rand 25 to rand 28.5,[5] and the rand return from the free-market premium was raised by 5%.

5. Under the December 1969 agreement, South Africa may sell up to one-fifth of one week's gold production to the IMF to the extent of its current payment needs, for each day the market price is below $35 per ounce. This created a floor price that presumably will be changed when the official price of gold is altered.

Table 3

South African Gold Sales to Swiss Banks
1971

	Metric Tons	Million US $ a/	Price (US $ per Fine Ounce) a/
January	53	64	37.56
February	65	81	38.77
March	71	88	38.54
April	63	79	38.99
May	59	77	40.59
June	68	88	40.26
July	60	80	41.47
August	51	70	42.68
September	44	58	40.99
October	72	98	42.33
November	53	72	42.25
December	61	85	43.35
Total	*720*	*940*	*40.60*

a. Prices approximate the actual transactions. A few individual transactions have been estimated.

16. In the two weeks preceding the Smithsonian agreement, speculators realized that any change in the official price of gold would be modest and that the future role of gold in the international monetary system would be reduced. This produced a rather sharp drop in price. Ironically, after the currency realignment, the London gold price rose again, from $42.75 to $43.625 per ounce at the end of the year. This rise can be attributed primarily to the large rand devaluation and continued uncertainty about the future of the international monetary system. After the first of this year, the weakness of the dollar on international currency markets and South Africa's restriction of sales from reserves produced a steady increase in gold prices to a 2 February 1972 peak of $49.25 – the highest free-market price since the establishment of the two-tier market. Since then, free-market prices have fluctuated around $48 an ounce.

Outlook

17. South Africa is unlikely to draw down its gold reserves much further, if at all, so that its free-market sales in 1972 will approximate current production. Pretoria's gold reserves, now at their lowest level in more than a decade, are less than the government considers adequate. Moreover, the outlook is for a considerable improvement in South Africa's balance of payments in 1972. Import restrictions, implemented in November, already have been eased somewhat. Although it will take time for the devaluation to affect exports, improved economic conditions in South Africa's major markets should allow exports to increase substantially. Higher free-market gold prices also mean that earnings from current gold production will be greater. Annual gold production by volume, however, may decline by 1% or 2%, as it did in 1971. The economics of gold mining dictate that, at higher prices, lower grade ores be mined, a development that reduces current production although it increases production over the long run by lengthening the mines' lifespan.

18. In January 1972 a Soviet economic lecturer, claiming to have been briefed by Gosplan, said that the USSR would resume gold sales this year with as much as $600 million-$700 million being involved over an indefinite time. Sales of this magnitude – between two and three times annual production – would not likely be completed in 1972, though sales of about $250 million may occur. The Soviets apparently believe that their gold reserves of nearly $2 billion are now large enough so that selling out of current production would be an acceptable policy to help finance their imports.

19. Average free-market gold prices during 1972 will probably be on the order of 20%-25% above the proposed new $38-per-ounce official price, if speculation subsides and no substantial Soviet sales take place. Much of the present price is a product of speculative pressure associated with uncertainty about the durability of the Smithsonian currency realignment. By mid-year, assuming Congress has officially raised the price of gold and the viability of the currency alignment is demonstrated, speculative pressure should dissipate. If the new speculative overhang[6] is sold and/or the Soviet Union makes large sales throughout the year, the price of gold will probably drop to below $45 an ounce. Nevertheless, by year's end the steady growth of non-speculative demand will probably force free-market prices back up to more than $45 an ounce.

6. Speculative purchases throughout 1971 created a new speculative overhang. Samuel Montagu and Co., Ltd., estimates the new overhang at about 186 tons. We have no evidence to contradict this estimate, but we suspect that it may be too large.

20. Significant developments in the official tier of the gold market are unlikely during 1972. The most important question is that of dollar convertibility to gold. Foreign central banks are pressing for limited convertibility for new incremental dollar holdings and/or some IMF transactions.